



July 23, 2018

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Re: Impact of Pub. L. No. 115-97 on Accounting Methods for Small Business Taxpayers

Dear Messrs. Kautter, Paul, Dinwiddie and Moriarty:

The American Institute of CPAs (AICPA) is pleased to submit recommendations with respect to the impact of Pub. L. No. 115-97 (commonly referred to as the Tax Cuts and Jobs Act (TCJA)) on accounting methods changes for small business taxpayers. Our recommendations include:

- 1) Provide automatic and simplified accounting method change procedures for small business taxpayers seeking to comply with the new provisions under the TCJA;
- 2) Clarify whether taxpayers that exceed the threshold for small business taxpayers in the future must file accounting method changes and provide certain automatic accounting method changes for such taxpayers to file the accounting method changes;
- 3) Clarify that the interest deduction limitation under Internal Revenue Code (IRC or "Code") section 163(j)¹ is not considered a method of accounting;
- 4) Provide relief for small business taxpayers, who meet the \$25 million gross receipts test, that are currently on improper accounting methods;
- 5) Clarify the definition of gross receipts under section 448 for purposes of qualifying as a small business taxpayer;

¹ All references to "section" or "§" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "regulations" are to U.S. Treasury regulations promulgated thereunder.

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- 6) Clarify that the definition of a tax shelter for purposes of section 448 does not include an entity with negative taxable income as a result of a negative section 481(a) adjustment;
- 7) Clarify that Qualified Improvement Property is treated as 15-year property; and
- 8) Provide guidance regarding the tax consequences of changing to the cash method of accounting.

These comments were developed by the AICPA Small Business Taxpayers Taskforce and approved by the AICPA Tax Methods and Periods Technical Resource Panel and Tax Executive Committee.

The AICPA is the world's largest member association representing the accounting profession with more than 431,000 members in 137 countries and territories, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

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We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact Jennifer Kennedy, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (703) 918-6951, or jennifer.kennedy@pwc.com; or Ogochukwu Anokwute, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9231, or ogo.anokwute@aicpa-cima.com or me at (408) 924-3508 or annette.nellen@sjsu.edu.

Sincerely,



Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Acting Commissioner, Internal Revenue Service
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of the Treasury

AMERICAN INSTITUTE OF CPAs

Comments on The Impact of Pub. L. No. 115-97 on Accounting Methods for Small Business Taxpayers

July 23, 2018

I. General Background

Pub. L. No. 115-97 (commonly referred to as the Tax Cuts and Jobs Act (TCJA)) contains numerous simplifying provisions allowing small business taxpayers to streamline their tax accounting methods for years beginning after December 31, 2017. The TCJA defines a small business taxpayer as a taxpayer with average annual gross receipts in the prior three-year period of \$25 million or less. The threshold of \$25 million is a welcome change for many taxpayers, as previous simplifying provisions with respect to certain accounting methods were generally applicable to taxpayers with gross receipts of \$1 million, \$5 million, \$10 million or less.

For purposes of determining whether a taxpayer qualifies as a small business taxpayer, the TCJA references the existing gross receipts test under Internal Revenue Code (IRC or “Code”) section 448(c)² and increases the dollar threshold from \$5 million to \$25 million. Thus, the \$25 million gross receipts test is determined by averaging a taxpayer’s gross receipts for the three prior taxable years. For example, if a taxpayer is assessing whether it may qualify for the simplifying provisions under the TCJA for its 2018 tax year, it would compute its average gross receipts using amounts from its 2015, 2016 and 2017 tax years (assuming no short taxable years and the taxpayer was in existence for the entire three-year period). If the average of the taxpayer’s gross receipts from its 2015, 2016 and 2017 tax years does not exceed \$25 million, then the taxpayer may apply the small business accounting method provisions under the TCJA for 2018. A qualifying small business taxpayer must then compute its prior three-year average gross receipts for each taxable year after 2018 to ensure that it may continue to utilize the simplifying provisions. If the taxpayer fails the \$25 million gross receipts test for a given taxable year, it may not apply any of the simplifying provisions for that taxable year.

In addition, prior to the TCJA, certain taxpayers that sought to use the cash method of accounting were required to satisfy the \$5 million gross receipts test for all prior taxable years beginning after December 31, 1985. If a taxpayer failed the gross receipts test for any prior taxable year, it was ineligible for the \$5 million gross receipts test exception, and therefore, not eligible to use the cash method. The TCJA modified section 448(b)(3) to allow the gross receipts test to apply to any taxable year where the gross receipts test is satisfied. This modification is a welcome improvement that permits a small business taxpayer to use the cash method in a subsequent year if it fails the \$25 million gross receipts test in a prior year.

The following discussion summarizes the simplifying accounting methods for taxpayers that meet the \$25 million gross receipts test under the TCJA as well as the application of the \$25 million gross receipts test for the business interest deduction limitation in section 163(j). Tax

² All references to “section” or “§” are to the Internal Revenue Code of 1986, as amended, and all references to “Treas. Reg. §” and “regulations” are to U.S. Treasury regulations promulgated thereunder.

shelters are not eligible for the gross receipts test and therefore are exempt from each of the simplifying provisions described below (that is, tax shelters are not considered a small business).³

Overall Method of Accounting

Section 448 generally requires C corporations, partnerships with a C corporation partner, and tax shelters to use the accrual method of accounting. Additionally, a taxpayer that engages in the purchase, production or sale of merchandise, as an income producing factor, must also use the accrual method of accounting.⁴ Presently, there are limited exceptions from these general rules; notably, taxpayers with gross receipts of \$1 million or less and \$10 million or less are exempt, under Rev. Proc. 2001-10 and Rev. Proc. 2002-28 (discussed in further detail below) respectively, from the requirement to use the accrual method of accounting.

Under the TCJA, all taxpayers may use the cash method of accounting if they meet the \$25 million gross receipts test, even if the purchase, production, or sale of merchandise is an income producing factor. Taxpayers not subject to section 448 (such as individuals and S corporations) may use the cash method. If the purchase, production, or sale of merchandise is an income producing factor and the \$25 million gross receipts test is not met, such excepted taxpayers may not use the cash method for the purchase and sale of merchandise (see next).

Accounting for Inventories

Consistent with the requirement to use the accrual method of accounting, taxpayers generally must account for inventories under section 471 if the production, purchase, or sale of merchandise is an income-producing factor to the taxpayer.⁵ However, an exception is provided under Rev. Proc. 2001-10⁶ for taxpayers whose average annual gross receipts do not exceed \$1 million. A second exception is provided under Rev. Proc. 2002-28⁷ for taxpayers in certain industries whose average annual gross receipts do not exceed \$10 million and that are not otherwise prohibited from using the cash method under section 448.

Under the TCJA, small business taxpayers meeting the \$25 million gross receipts test can either treat inventories as non-incidental materials and supplies or conform to the taxpayer's Applicable Financial Statement. If the taxpayer doesn't have an Applicable Financial Statement, it may account for inventories in conformity with respect to its books and records in accordance with its accounting procedures under section 471(c)(1)(B). This rule applies regardless of the taxpayer's industry. Non-incidental materials and supplies are generally deducted in the year the amounts are first used or consumed.

Section 263A

Section 263A uniform capitalization (UNICAP) rules require taxpayers to capitalize certain direct and indirect costs to allocable real or tangible personal property, produced by the

³ IRC section 448(b)(3).

⁴ Treasury Reg. § 1.446-1(c)(2).

⁵ IRC section 471(a) and Treas. Reg. § 1.471-1.

⁶ 2001-1 C.B. 272.

⁷ 2002-1 C.B. 815.

taxpayer, to inventory or the basis of such property, as applicable. For real or personal property acquired by the taxpayer for resale, section 263A generally requires the inclusion of certain direct and indirect costs allocable to such property in inventory.

Prior to the TCJA, there were several exceptions to the requirement to capitalize costs under section 263A. For instance, taxpayers that acquire property for resale and have \$10 million or less of average annual gross receipts are not required to capitalize additional section 263A costs in inventory under section 263A(b)(2)(B). Another exception provides an exemption from the UNICAP requirements for taxpayers that produce property but incur \$200,000 or less in total indirect costs.

The TCJA expands the exemption from UNICAP to include all taxpayers meeting the \$25 million gross receipts test, including producers. As such, small business taxpayers are no longer required to capitalize additional section 263A costs to inventory or the basis of property produced.

Long Term Contracts

In the case of a long-term contract, the taxable income from the contract is generally determined under the percentage-of-completion method (PCM). Under the PCM, the taxpayer must include, in gross income for the taxable year, an amount equal to the product of the gross contract price and the percentage of the contract completed during the taxable year. The percentage of the contract completed during the taxable year is determined by comparing costs allocated to the contract and incurred before the end of the taxable year, with the estimated total contract costs. Costs allocated to the contract typically include all costs (including depreciation) that directly benefit or are incurred by reason of the taxpayer's long-term contract activities. The allocation of costs to a contract is made in accordance with regulations. Costs incurred with respect to the long-term contract are deductible in the year incurred, subject to general accrual method of accounting principles and limitations.

Section 460(e)(1)(b) exempts small construction contracts from the requirement to use the PCM. Prior to the enactment of the TCJA, small construction contracts were defined as contracts for the construction or improvement of real property if:

- Completion of the contract is expected (at the time such contract is entered into) within two years of commencement of the contract; and
- Performance of the contract is by a taxpayer whose average annual gross receipts for the prior three taxable years does not exceed \$10 million.

The TCJA expands the exception for small construction contracts from the requirement to use the PCM. Under the provision, contracts within this exception are those contracts for the construction or improvement of real property if:

- Completion of the contract is expected (at the time such contract is entered into) within two years of commencement of the contract; and

- Performance of the contract is by a taxpayer that (for the taxable year in which the contract was entered into) meets the \$25 million gross receipts test.

Section 163(j)

The TCJA introduced a revised interest expense limitation under section 163(j). For taxable years beginning after December 31, 2017, the TCJA limits a taxpayer's deduction of business interest to the sum of:

- Business interest income;
- 30 percent of the adjusted taxable income; and
- Floor plan financing interest for such year.

Any disallowed amount is carried forward and treated as business interest paid or accrued in the next succeeding tax year. Special rules are provided for the computation of adjusted taxable income and how the section applies to partnerships and S corporations.

A taxpayer is exempt from the interest expense limitation under section 163(j) if it meets the \$25 million gross receipts threshold. Additionally, the limitation of 163(j) does not apply to an electing real property trade or business or electing farming business, but those businesses must also use the alternative depreciation system (ADS) for certain assets. Finally, the limitation does not apply to certain public regulated utilities.

II. Recommendations for Procedural Guidance for Small Business Taxpayers

To reduce the unnecessary compliance burdens associated with making accounting method changes to adopt the small business taxpayer provisions in the TCJA, the American Institute of CPAs (AICPA) recommends that the Internal Revenue Service (IRS) and the Department of the Treasury ("Treasury") provide qualifying small business taxpayers with the following:

- 1) Automatic accounting method changes for certain small business taxpayer provisions in TCJA; and
- 2) Reduced filing requirement, with audit protection, by attaching a statement to a timely filed tax return, including extensions, in lieu of filing Form 3115, *Application for Change in Accounting Method*.

Provide Additional Automatic Accounting Method Changes

Recommendations

The IRS and Treasury should add the following accounting method changes to the current list of automatic changes:

- 1) Change to the Cash Method – A new automatic accounting method change to allow taxpayers that meet the \$25 million gross receipts test to change to the cash method in any taxable year that it qualifies.
- 2) Section 263A – A new UNICAP automatic accounting method change, for any taxpayer (reseller or producer) that meets the \$25 million gross receipts test, to change to a permissible non-UNICAP inventory capitalization method in any taxable year that it qualifies.
- 3) Section 471 – A new section 471 automatic accounting method change, for taxpayers that meet the \$25 million gross receipts test, to change from any method of accounting for inventories, to treating such amounts as either non-incidental materials or supplies or conforming to financial statement treatment (if the taxpayer has an Applicable Financial Statement) in any taxable year that it qualifies. If the taxpayer does not have an Applicable Financial Statement, to change from any method of accounting for inventories to either treating amounts as non-incidental materials or supplies or conforming to its books and records prepared in accordance with its accounting procedures. Additionally, include guidance specifically for taxpayers that currently treat inventory as non-incidental materials and supplies under Rev. Proc. 2002-28 or Rev. Proc. 2001-10. For taxpayers without an Applicable Financial Statement, guidance should confirm that accountants’ workpapers are part of the books and records of the taxpayer.
- 4) Section 460 – Allow taxpayers that meet the \$25 million gross receipts test to file an automatic accounting method change (on a cut-off basis) to no longer use the PCM for eligible contracts in any taxable year that it qualifies.

We recommend making the above changes in methods of accounting with a section 481(a) adjustment⁸ and provide the taxpayer with audit protection. For taxpayers under examination, we also recommend that the IRS and Treasury allow for audit protection for the accounting method changes and, if the taxpayer under examination has a positive section 481(a) adjustment, allow the taxpayer to utilize a four-year spread period.

Furthermore, the IRS and Treasury should waive the automatic accounting method change eligibility rules under section 5.01(1) of Rev. Proc. 2015-13 for all four accounting method changes listed above for any year of change.

Analysis

The list of accounting method changes that qualify for the automatic consent procedures is provided under Rev. Proc. 2018-31 and includes the following:

- 1) Change to the Cash Method – Under section 15.03 of Rev. Proc. 2018-31, the only automatic accrual to cash change applies to taxpayers eligible to use the cash method of accounting under Rev. Proc. 2001-10 and Rev. Proc. 2002-28. The number of

⁸ Application of the exception for small construction contracts from the requirement to use the PCM is applied on a cutoff basis as outlined in the TCJA for contracts entered into before January 1, 2018.

taxpayers able to use the cash method of accounting under the TCJA is significantly larger than those taxpayers that qualified to use the cash method under either of the revenue procedures. Therefore, a new automatic accounting method change will reduce the compliance burdens for small business taxpayers.

- 2) Section 263A – Under section 12.01 of Rev. Proc. 2018-31, only small resellers (i.e., taxpayers that engage in the resale of inventory and have less than \$10 million of average annual gross receipts) may file an automatic accounting method change to change to a non-UNICAP inventory capitalization method. Adding the UNICAP accounting method change as a new automatic accounting method change will reduce the compliance burden for small business taxpayers.
- 3) Section 471 – Section 22.03 of Rev. Proc. 2018-31 allows taxpayers that meet the requirements of Rev. Proc. 2001-10 or Rev. Proc. 2002-28 to file an automatic accounting method change to treat inventorable items in the same manner as non-incidentals materials and supplies. Adding a new section 471 automatic accounting method change for taxpayers that meet the \$25 million gross receipts test, to change from any method of accounting for inventories to treating such amounts as either non-incidentals materials or supplies or conforming to financial statement treatment (or the accounting procedures per the books and records if the taxpayer has no applicable financial statement), will reduce the compliance burden for small business taxpayers.
- 4) Section 460 – Currently, all section 460 changes are non-automatic. Adding a new section 460 automatic accounting method change (on a cut-off basis) for taxpayers that meet the \$25 million gross receipts test to no longer use the PCM will reduce the compliance burden for small business taxpayers.

Section 446(e) and the regulations thereunder require a taxpayer to secure the consent of the Secretary of the Treasury before changing its method of accounting. Generally, a taxpayer must file a Form 3115 to obtain the IRS's consent. Revenue Proc. 2015-13 provides the procedural rules for making accounting method changes, both automatic and non-automatic. Automatic accounting method changes are typically less administratively burdensome to implement as compared to non-automatic accounting method changes and, unlike non-automatic accounting method changes, do not require a filing fee.

The eligibility rules under section 5.01(1) of Rev. Proc. 2015-13 list several conditions that generally preclude taxpayers from making an automatic accounting method change (including, for instance, if the year of change is the final year of the trade or business or if the taxpayer has made or requested a change for the same item during any of the five taxable years ending with the year of change). An eligibility waiver will permit taxpayers to comply with simplified provisions in the TCJA without the requirement of having to file a non-automatic accounting method change. The IRS provided a similar waiver to assist taxpayers in complying with the substantial new rules under the tangible property regulations issued in 2013 and 2014.

As these accounting method changes are straightforward, allowing taxpayers to make the changes under the automatic accounting method change provisions will significantly reduce the burdens associated with small business taxpayers seeking to comply with the TCJA.

Taxpayers that file a Form 3115 while under exam generally do not receive audit protection or the four-year spread period of a positive section 481(a) adjustment under section 8.02(1) and section 7.03(3)(b) of Rev. Proc. 2015-13. We recommend that the IRS waive these exceptions for the method changes listed above to allow a taxpayer under examination to file an accounting method change and obtain audit protection and, if the taxpayer under examination has a positive section 481(a) adjustment, allow it to utilize a four-year spread period.

Streamlined Reduced Method Filing Procedures in Lieu of a Form 3115

Recommendations

To reduce the administrative burdens and costs on small business taxpayers and the IRS, the IRS and Treasury should provide qualifying small business taxpayers with reduced filing requirements to change to one or more of the below simplifying conventions provided under the TCJA:

- 1) Use of the cash method of accounting;
- 2) Treatment of inventoriable items in accordance with section 471(c)(1)(B);
- 3) Use of a permissible non-UNICAP inventory capitalization method; and
- 4) Application of exemption from use of the PCM for small construction contracts.

Specifically, we recommend that the IRS and Treasury permit a qualifying small business taxpayer to change its method of accounting, with audit protection and a section 481(a) adjustment (if applicable), for the above identified changes, by including a statement in its tax return for the year of the change in lieu of filing a Form 3115. We recommend that the statement filed in the tax return, as part of the reduced filing provision, include the following information:

- 1) The designated automatic accounting change number(s);⁹
- 2) The taxpayers' name and employer identification number for each applicant as required on a Form 3115;
- 3) The year of change (both the beginning and ending dates);
- 4) A description of the present and proposed methods for each applicant; and
- 5) Section 481(a) adjustment for each automatic change, if applicable.

If the IRS and Treasury instead require taxpayers to prepare a complete Form 3115 for the accounting method changes listed above, we recommend that they allow taxpayers to have the option to combine all four changes above (or any combination of the four) on a single Form 3115.

⁹ See discussion above for AICPA's recommendations for additions to the current list of automatic accounting method changes.

Analysis

The Joint Explanatory Statement of the TCJA notes that application of the provisions to expand the taxpayer eligibility to use the cash method, to exempt certain taxpayers from the requirement to keep inventories, and to expand the exception from the UNICAP rules is considered a change in the taxpayer's method of accounting for purposes of section 481. Many taxpayers will take advantage of these simplifying conventions. As such, it is important that the IRS and Treasury promptly provide procedural guidance to allow taxpayers adequate time to complete the necessary steps to change their methods of accounting.

The proposed reduced filing requirement, with audit protection, would reduce the administrative compliance burden on small business taxpayers, which is in line with the intention behind the new accounting method provisions. The IRS provided a similar waiver permitting taxpayers using the deferral method of accounting for advance payments, to file a statement in lieu of a Form 3115 when the taxpayer changes the manner in which it recognizes advance payments in revenues in its applicable financial statement.¹⁰

Under section 6.02 of Rev. Proc. 2015-13, taxpayers generally must submit a separate Form 3115 for each automatic accounting method change. Allowing all small business taxpayers to combine all four changes above (or any combination of the four) on a single Form 3115, provided each section 481(a) adjustment is separately disclosed, will simplify the process of implementing the accounting method changes. This provision is consistent with the accounting method changes for the tangible property regulations under section 11.08 of Rev. Proc. 2018-31.

III. Automatic Accounting Method Changes for Former Small Business Taxpayers

Recommendations

With respect to taxpayers that are required to use the overall accrual method of accounting, and/or become subject to sections 263A, 471 and 460, the IRS and Treasury should clarify that the change to no longer use the simplifying provisions of the TCJA is considered an accounting method change for purposes of section 481.

The IRS and Treasury should update Rev. Proc. 2018-31 to specifically allow taxpayers that no longer meet the \$25 million gross receipts test to file automatic accounting method change(s) for the following:

- 1) Overall Cash to Accrual – Waive the eligibility rules for taxpayers requesting an accounting method change under the small business provisions of the TCJA.
- 2) Section 263A – Update sections 12.01 and 12.02 of Rev. Proc. 2018-31 specifically to allow a former small business taxpayer under the TCJA, to change from a permissible non-UNICAP inventory method to a permissible UNICAP method in the first taxable year that it does not qualify as a small business taxpayer. We also recommend waiving

¹⁰ Section 16.10(2)(b) of Rev. Proc. 2018-31.

the eligibility rules under section 5.01(1) of Rev. Proc. 2015-13, for taxpayers that previously filed an accounting method change to use a permissible non-UNICAP inventory method under the provisions of the TCJA.

- 3) Section 471 – Provide guidance permitting taxpayers that were previously exempt from the requirements of section 471 under the TCJA to change to a permissible method of accounting for identifying and valuing inventories. We also recommend waiving the eligibility rules under section 5.01(1) of Rev. Proc. 2015-13, for taxpayers that previously filed an accounting method change for exemption from section 471 under the provisions of the TCJA.
- 4) Section 460 – Clarify that taxpayers exceeding the \$25 million gross receipts test of section 460 should adopt a permissible method of accounting under section 460 for long-term contracts. We also recommend waiving the eligibility rules under section 5.01(1) of Rev. Proc. 2015-13, for taxpayers that previously filed an accounting method change for exemption from section 460 under the provisions of the TCJA.

Analysis

If a taxpayer's gross receipts exceed the \$25 million gross receipts threshold, it may not apply any of the simplifying provisions for the taxable year in which it no longer qualifies as a small business taxpayer (other than for taxpayers not subject to section 448).

- 1) Overall Cash to Accrual – Presently, section 15.01 of Rev. Proc. 2018-31 allows taxpayers to file an automatic accounting method change to change from cash to accrual and waives the prior change eligibility rule for any prior change to the cash method made under the provisions of Rev. Proc. 2001-10 and 2002-28.
- 2) Section 263A – The existing language in section 12.01(1)(a)(ii) of Rev. Proc. 2018-31 allows a former small reseller to change to permissible UNICAP methods under the automatic provision.
- 3) Section 471 – Sections 22.11 and 22.18 of Rev. Proc. 2018-31 allow taxpayers to file automatic accounting method changes to change to permissible methods of identifying and valuing inventories.
- 4) Section 460 – It is unclear whether taxpayers exceeding the \$25 million gross receipts test of section 460 should adopt a permissible method of accounting under section 460 for long-term contracts.

IV. Section 163(j)

Recommendations

The IRS and Treasury should clarify that the application of section 163(j) to formerly small taxpayers that exceed the \$25 million gross receipts threshold does not constitute a method of accounting in the year that the taxpayer exceeds the threshold.

Analysis

Taxpayers that meet the \$25 million gross receipts test are exempt from the section 163(j) limitation on the deduction of business interest for any taxable year.

Section 163(j) does not include any coordinating language with section 481 which, for comparison purposes, is included in sections 448, 460, 471 and 263A (among other sections of the Code). As such, it appears that the application of the section 163(j) limitation does not constitute a method of accounting that would require a change in accounting method request for a taxable year in which the taxpayer no longer meets the \$25 million gross receipts test. Therefore, a change of method of accounting request is not required for the any taxable year the taxpayer is or is not subject to the limitation due to passing or failing, respectively, the \$25 million gross receipts test.

V. Relief for Taxpayers Currently on Improper Methods

Recommendations

The IRS should direct examiners to stand down or suspend current examination activity for taxpayers with average annual gross receipts of \$25 million or less for the year(s) under exam on certain issues involving:

- 1) Whether the taxpayer is required to use the accrual method of accounting due to the taxpayer failing to meet the pre-TCJA \$5 million of average annual gross receipts test under section 448;
- 2) Whether the taxpayer is required under section 263A to capitalize certain direct and indirect costs (including interest expense, if applicable) to inventory or to the basis of real or tangible personal property produced by the taxpayer;
- 3) Whether the taxpayer is required to maintain an inventory method under section 471; and
- 4) Whether the taxpayer is required to account for contracts under the PCM method of accounting under section 460.

Additionally, the IRS should provide prior year audit protection for each of the small business accounting method reforms and simplification provisions listed above and for examination of years beginning before January 1, 2018:

- 1) Exam agents should discontinue current exam activity with regard to the small business reforms and simplification provisions of TCJA (“the Issues”);
- 2) Exam should not begin any new exam activity with regard to the Issues; and
- 3) If a taxpayer has filed Form 3115 with regard to the Issues or is deemed to have adopted certain provisions of TCJA, the exam agent may risk assess the section 481(a) adjustment and determine whether to examine the adjustment.

Analysis

Small business taxpayers, when reviewing the applicability of the TCJA small business accounting method reform and simplification provisions, could find that their historical methods of accounting are not in compliance with the Code and regulations thereunder.

The AICPA requests both a stand down and prior year audit protection for each of the small business accounting method reforms and simplification provisions listed above. This approach is appropriate given the uncertainty as to whether audit protection (provided as part of consent to change a method of accounting) would cover certain situations for which the new method of accounting is an exemption to certain methods of accounting required under previous law.

For example, section 263A(i) provides that a taxpayer that meets the gross receipts tax is exempt from the requirement to compute tax inventory adjustments under the UNICAP requirements. If the taxpayer did not previously meet any of the various UNICAP exceptions, and was otherwise required to compute tax inventory adjustments, it is unclear whether the exemption from UNICAP requirements in the TCJA, and a change to that method of accounting, provide adequate audit protection to the taxpayer for historical years.

The IRS has a history of easing administrative burden, especially for small business taxpayers. The adoption of the tangible property regulations is a recent example. In Rev. Proc. 2015-20, the IRS provided procedures for a small business taxpayer, defined as a separate and distinct trade or business with total assets of less than \$10 million or average annual gross receipts of \$10 million or less for the prior three taxable years, to make certain tangible property changes in method of accounting with an adjustment under section 481(a) that takes into account only amounts paid or incurred, and dispositions, in taxable years beginning on or after January 1, 2014. Revenue Proc. 2015-20 modified certain procedures provided in Rev. Proc. 2015-14 to allow small business taxpayers to effectively elect to make tangible property related changes on a cut-off basis. However, the adoption of certain tangible property changes under Rev. Proc. 2015-20 did not provide audit protection to a small business taxpayer for taxable year beginning prior to January 1, 2014.

A stand down or suspension of current exam activity surrounding the provisions described above is in the interest of the IRS to both further ease the administrative burden of small business taxpayers and its own administrative burdens. Adjustments with respect to the timing of deductions and income for taxpayers that meet the gross receipts test will reverse within one or two years. The taxpayer, by then, will qualify under the revised gross receipts test. In addition, any simplified procedures provided to adopt the small business taxpayer reforms and simplification provisions of the TCJA should provide audit protection for previous tax years for a taxpayer's overall method of accounting, the UNICAP requirements, the requirement to maintain inventory under section 471, and the use of the PCM method under section 460.

VI. Clarification of Gross Receipts Determination

Recommendations

For purposes of applying the gross receipts test, the IRS and Treasury should provide additional guidance for defining “gross receipts” under section 448. We recommend clarifying that the current definitions found in Treas. Reg. § 1.448-1T(f)(2) continue to apply with respect to:

- 1) The aggregation of gross receipts, particularly the last sentence in Treas. Reg. § 1.448-1T(f)(2)(ii) regarding transactions between persons who are treated as a common employer;
- 2) The treatment of a short taxable year; and
- 3) The determination of gross receipts.

Analysis

Using existing definitions in Treas. Reg. § 1.448-1T(f)(2) is administratively reasonable, provides for consistent application of the definitions across the Code, and new definitions are unwarranted if section 448 does not present unique concerns.

VII. Clarification of Tax Shelter Definition

Recommendations

The IRS should clarify that a negative section 481(a) adjustment that arises for a small business taxpayer, which results in negative taxable income, will not result in the classification of the taxpayer as a tax shelter in that tax year, thus making it ineligible for adopting accounting method changes allowed by the TCJA.

Analysis

Taxpayers are concerned with the definition of tax shelter under section 448 as it applies to the new small business methods of accounting, including the exception from the interest expense limitation. In particular, the term “tax shelter” includes a syndicate, which is defined in section 1256(e)(3)(B) as any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs. Under Treas. Reg. § 1.448-1T(b)(3), an entity is only a syndicate in years with a taxable loss. For business that have losses in some years and income in others, this definition could result in eligibility for the special methods in some years and not other years, thereby requiring small business taxpayers to change from methods of accounting allowed by the TCJA.

In addition, the AICPA is concerned that if a small business taxpayer changes its method(s) of accounting, the change(s) could result in a negative section 481(a) adjustment. The inclusion of the negative section 481(a) adjustment in the computation of taxable income could result in consideration of the taxpayer as a tax shelter in that tax year and render the taxpayer ineligible

to use certain accounting methods allowed by the TCJA. Thus, the AICPA recommends that the IRS and Treasury clarify that if a small business taxpayer reports negative taxable income, as a result of a negative section 481(a) adjustment, it is not considered a tax shelter that is otherwise ineligible to use the methods of accounting allowed by the TCJA.

VIII. Guidance for Qualified Improvement Property

Recommendations

The IRS should assign qualified improvement property (QIP) a 15-year general depreciation system (GDS) and 20-year ADS recovery period for assets placed into service after December 31, 2017, as intended by Congress, demonstrated in the explanatory statements and the modifications to sections 168(e), (g) and (k) in the TCJA.

The IRS and Treasury should promptly issue guidance addressing the depreciation classification of QIP. The cost recovery of QIP will have a significant effect on business decisions and tax payments.

Analysis

Pre-Enactment of TCJA

Prior to the TCJA, a special depreciation allowance, commonly referred to as “bonus depreciation,” was available for 50 percent of the cost of qualified property placed in service before January 1, 2018. Qualified property was defined in section 168(k)(2)(A) as property:

- With a recovery period of 20 years or less;
- Computer software;
- Water utility property; or
- QIP.

Prior to the TCJA, QIP was defined in section 168(k)(3) as improvements to an interior of non-residential real property, excluding costs for the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

Prior to the TCJA, QIP was specifically defined under section 168(k) as eligible property for bonus depreciation.

Post-Enactment of TCJA

The TCJA increased bonus depreciation to 100 percent of the cost of eligible property and revised the application of bonus depreciation. Specifically, the definition of QIP was eliminated from previous section 168(k)(3) and relocated to section 168(e)(6). The definitions of qualified leasehold improvement property, qualified restaurant property, and qualified retail

improvement property were eliminated along with their 15-year depreciation classification under the GDS, as a result of the relocation of the definition of QIP.

The TCJA assigns the straight-line depreciation method to “qualified improvement property described in subsection (e)(6).”¹¹ The TCJA assigns QIP an ADS cost recovery period by amending the table in section 168(g)(3)(B) and inserting a line item assigning a 20-year recovery period to property in section 168(e)(3)(D)(v). However, section 168(e)(3)(D)(v) is undefined. Section 168(e)(3)(D) defines property in the 10-year GDS classification. Subparagraph (E) defines property in the 15-year classification. Neither section 168(e)(3)(D) nor (E) assigns a GDS classification to QIP.

The Conference Agreement explanatory statements to Congress classify QIP as 15-year GDS property. If QIP were classified as a 15-year GDS property, QIP would have been eligible for bonus depreciation under section 168(k)(2)(A)(i)(I) as property with a recovery period of 20 years or less. However, this provision was not included in the final legislation signed into law.

Based on the explanatory statements and the revisions noted above to section 168(e) and (g), it appears Congress’ intent was to assign QIP a 15-year GDS recovery period at section 168(e)(3)(D)(v), which is also complimentary of the ADS depreciation methods assigned to QIP in section 168(g).

As currently drafted in the TCJA, it appears that QIP placed in service after December 31, 2017, is assigned a recovery period of 39 years under GDS for nonresidential real property and is not eligible for bonus depreciation. The IRS has a history of assigning cost recovery periods to property and should therefore issue guidance with classification for QIP.¹²

IX. Guidance Regarding Tax Consequences of The Cash Method of Accounting

Recommendations

The IRS and Treasury should provide guidance explaining the tax consequences that result for a small business taxpayer that purchases or produces merchandise for sale to customers, which adopts the cash method of accounting and the non-incidental materials and supplies method, to account for its inventory.

We also recommend that the IRS and Treasury permit small business taxpayers to make a *de minimis* election under Treas. Reg. § 1.263(a)-1(f) to enable the taxpayer to expense the cost of any purchased raw materials or finished merchandise purchased for resale, if those costs otherwise satisfy the requirements for a *de minimis* election in Treas. Reg. § 1.263(a)-1(f).

The IRS and Treasury should issue guidance that states that a small business taxpayer that adopts the cash method of accounting may deduct all of the labor and overhead costs associated with the purchase or production of the inventory items.

¹¹ IRC section 168(b)(3)(G).

¹² Numerous precursors to Rev. Proc. 87-56, including, Rev. Procs. 62-21, 77-10, 80-15 and 83-35 among others; Rev. Proc. 87-56 – IRS Recovery Period Table for MACRS; Rev. Proc. 2003-63 – Classification of Fiber Optic Cable; Rev. Proc. 2011-22 – Classification of Wireless Telecom Assets.

Analysis

Non-Incidental Materials and Supplies Accounting Method

Under the TCJA, a small business taxpayer adopting the cash method may treat inventory as non-incidental materials and supplies. The consequence of treating inventory as a non-incidental material and supply is that the cost of the inventory is deductible when the inventory is used or consumed (assuming it has been paid for as required under the cash method of accounting). However, no explanation is provided on how the cost basis of inventory items treated as non-incidental materials and supplies is determined.

De minimis election, under Treas. Reg. § 1.263(a)-1(f)

Prior to the enactment of section 263A, the cost of non-incidental materials and supplies included the costs incurred by a taxpayer in acquiring the materials and supplies. However, Treas. Reg. § 1.263(a)-1(f)(1) offers taxpayers the option to elect to apply a *de minimis* safe harbor with respect to the acquisition or production of depreciable property costing less than \$5,000/unit (or \$2,500/unit in the case of a taxpayer without an applicable financial statement). The *de minimis* election is applied to eligible non-incidental materials and supplies pursuant to the requirements in Treas. Reg. § 1.263(a)-1(f)(1). Treasury Reg. 1.263(a)-1(f)(1) provides that a taxpayer must apply any safe harbor *de minimis* election to any type of eligible property that is treated as a material or supply within the meaning of Treas. Reg. § 1.162-3.

Treasury Reg. § 1.263(a)-1(f)(2) provides that the *de minimis* safe harbor election for materials and supplies does not apply to any property that is considered as inventory. However, the determination of whether a material or supply is or is not considered as inventory is based on whether the property is subject to the provisions in section 471. Treasury Reg. § 1.263(a)-1(f)(1) does not contain its own separate definition of whether a material or supply is considered as inventory.

Accordingly, we recommend that the IRS and Treasury permit a small business taxpayer to make a *de minimis* safe harbor election that would enable the taxpayer to expense the cost of purchased raw materials or purchased finished merchandise if the cost of those items do not exceed the cost thresholds in Treas. Reg. § 1.263(a)-1(f)(1)(i) & (ii).

Production Labor and Overhead Costs

If the taxpayer meets the gross receipts test, the taxpayer's determination of the cost of any inventory that it produces is governed by section 471(c)(1)(B). Notice 88-86¹³ provides insight on the law that existed prior to the enactment of section 263A with respect to the determination of non-incidental materials and supplies produced by a taxpayer.

Section D of Notice 88-86 discusses the intended application of section 263A to non-incidental materials and supplies and notes that such treatment depends on whether the materials and supplies are subject to section 263A by a taxpayer that is not engaged in a business with inventories. The Notice indicates that section 263A is intended to apply in that type of situation

¹³ Which explained the scope of section 263A prior to the issuance of regulations under that section.

only if the materials and supplies are significant in amount. This rule was later codified in the provisions in Treas. Reg. § 1.263A-1(b)(11). As non-incidental materials and supplies, we recommend that the IRS and Treasury acknowledge that the items are not significant in amount.

However, in example one in section D of Notice 88-86, the IRS provides an illustration involving an architect providing design services. The Notice concludes that the blueprints and drawings that the architect supplies to its clients are not subject to section 263A. Since the architect is not subject to section 263A, the architect is not required to capitalize the salaries of any employees that worked on the drawings and blueprints into the cost of the blueprints and drawings. Also, the architect is not required to capitalize any of the architectural firm's overhead into the cost of the drawings and blueprints. Presumably, the same conclusion would apply, for example, to an attorney that supplies legal documents to a client as part of the legal services provided by the attorney.

The AICPA submits that the same result should apply to a taxpayer that meets the gross receipts test that treats inventory as non-incidental materials and supplies. By virtue of meeting the gross receipts test, the taxpayer is exempted from the requirements in section 263A and is placed in the same position as the architect in the first example in section D of Notice 88-86. Accordingly, we recommend that the IRS and Treasury clarify that a taxpayer that meets the gross receipts test need not capitalize into the basis of the inventory any of the taxpayer's production labor and overhead costs. Thus, the only capitalized costs are the costs of any raw materials purchased or any finished merchandise purchased for resale. Further, capitalizing these costs is not needed if the expenditures are not capitalized in the taxpayer's books and records prepared in accordance with the taxpayer's accounting procedure and the taxpayer does not have an Applicable Financial Statement.